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711692—46

In the Supreme Court of the United States

OCTOBER TERM, 1946

No. 244

DEWEY SCHMOLL, SUCCESSOR ASSIGNEE FOR THE BENEFIT OF CREDITORS, ETC., AND NATIONAL SURETY CORPORATION, PETITIONERS

v.

THE UNITED STATES

ON PETITION FOR A WRIT OF CERTIORARI TO THE COURT OF CLAIMS

BRIEF FOR THE UNITED STATES IN OPPOSITION

OPINION BELOW

The opinion of the Court of Claims (R. 64–72) has not yet been reported.

JURISDICTION

The judgment of the Court of Claims was entered on January 7, 1946 (R. 72). Motions for a new trial filed by petitioners and respondent were overruled on April 1, 1946 (R. 72–73). The petition for a writ of certiorari was filed on June 28, 1946. The jurisdiction of this Court is invoked

under Section 3 (b) of the Act of February 13, 1925, as amended by the Act of May 12, 1939.

QUESTION PRESENTED

Whether in a suit for the balance due on certain construction contracts, brought by the insolvent contractor's assignee and the surety who had satisfied all labor and material claims, the United States, by virtue of R. S. 3466, is entitled to offset debts due the United States by the contractor for (1) capital stock taxes, and (2) for correcting defective work under two separate contracts on which there had been a different surety.

STATUTES INVOLVED

The relevant portions of the statutes involved are set forth in the Appendix, *infra*, pp. 12–13.

STATEMENT

Between November 19, 1933 and March 19, 1935, Murch Brothers Construction Co., Inc. (the "contractor"), entered into 17 contracts with the United States for the construction and remodeling of post offices (R. 32). National Surety Corporation (the "surety"), a petitioner herein, became surety on the payment and performance bonds furnished to the United States pursuant to the Act of August 24, 1935 (Appendix, *infra*, pp. 12–13) (R. 34). On June 22, 1935, due to lack of funds, the contractor suspended work on the contracts (R. 34). On June 27, 1935, the United States terminated the contractor's right to proceed, and

let contracts to others for the completion of the work (R. 35). On January 3, 1936, the contractor made an assignment for the benefit of its creditors (R. 32). The surety paid labor and material claims totaling $202,011.66, and it was agreed between the surety and the successor assignee for the benefit of creditors (the petitioners herein) that the surety was entitled to be subrogated for that amount (R. 47). After deducting the total amount which the United States paid to the contractor and to the completing contractors, there remained an unpaid balance of $55,197.57 of the total of the contract prices (R. 47). From this balance, the General Accounting Office deducted: (1) $31,547.80 as expenses incident to the contractor's default, (2) $2,552.43 for correcting defective work done by the contractor on separate Veterans' Administration contracts upon which the National Surety Corporation had not been surety, and (3) $206.53 for capital stock taxes which the contractor owed the United States—a total deduction of $34,306.76 (R. 48). The General Accounting Office then suspended payment of the acknowledged balance because of its uncertainty as to the person to whom payments should be made (R. 37). Thereafter, petitioners instituted eleven suits in the Court of Claims to recover $64,175.83, for the balance allegedly due on the contracts, for damages from delay allegedly caused by the United States, and for work per-

formed under protest by the contractor (R. 1–11). The United States filed a general traverse in each case, and, by order of the court, the cases were consolidated (R. 27, 32). On April 5, 1944, the United States filed a counterclaim for the items deducted by the General Accounting Office (R. 27–31), and petitioners filed a replication thereto (R. 27–31). After a trial on the merits, the Court of Claims entered Special Findings of Fact and Conclusion of Law, sustaining the deductions made by the General Accounting Office, but awarding judgment, in favor of the surety, for $30,015.58, of which $9,124.77 was for damages for delays caused by the Government, and the remainder for the net balance due on the contracts (R. 32–64, 69–72).

ARGUMENT

Contrary to petitioners' contentions, the question here presented is a narrow one. The only problem is whether, where an insolvent debtor has made an assignment for the benefit of creditors, the priority in payment conferred on a debt due the United States takes precedence over a claim to unpaid contract balances made by a surety who has paid claims for labor and material. Section 3466 of the Revised Statutes provides that: "Whenever any person indebted to the United States is insolvent * * * the debts due to the United States shall be first satisfied" (Appendix, *infra*, p. 12). The court below held

that the contractor herein, having made an assignment for the benefit of its creditors, had manifested its insolvency in a manner covered by the statute (*United States* v. *Emory,* 314 U. S. 423, 426); that the claims of the United States for capital stock taxes and for correcting defective work under other contracts were entitled to priority over the claim of the surety; and that such claims might be offset against the contract balance withheld by the Comptroller General. In so holding, we submit that the court below was clearly correct.[1]

1. Since the offset items were unquestionably "debts due to the United States," they would, in an action against the assignee, be entitled to priority over claims of other creditors (*Illinois ex rel. Gordon* v. *United States,* No. 749, Oct. 7, 1945, decided April 22, 1946; *United States* v. *Emory,* 314 U. S. 423), including claims secured by liens where such liens were not specific and perfected. See *United States* v. *Waddill Co.,* 323 U. S. 353, 355, and cases there cited. Assuming, as petitioners contend (Pet. 7–13), that the surety herein has an equitable lien upon the unpaid contract balances, the surety's claim could not prevail over that of the United States in an

[1] Petitioners have apparently abandoned their contention made in the court below (R. 64–66) that the General Accounting Office erred in deducting, as an expense incidental to the contractor's default, the rental paid for temporary quarters for post offices between the completion dates specified in the contracts and the actual dates of completion.

action against the assignee, since such a lien is neither specific nor perfected.[2]

The fact that in the instant case the Government's claim is asserted as an offset to the claim of petitioners, rather than in an original proceeding against the assignee, in no way alters the Government's right to priority. By permitting the offset, the court below not only obeys "the plain command of § 3466 that 'debts due to the United States shall be first satisfied' " (*United States* v. *Emory,* 314 U. S. 423, 426), but avoids " 'circuity of action, inconvenience, expense, consumption of the courts' time, and injustice' " (*Cherry Cotton Mills, Inc.* v. *United States,* No. 187, Oct. T. 1945, decided March 25, 1946). Moreover, the decision below is consistent with *United States* v. *National Surety Co.,* 254 U. S. 73, where this Court flatly rejected the contention of a surety that, having fulfilled the obligation of its bond, it was entitled, under R. S. 3468, to share in the bankrupt's assets equally with the Government.

[2] Petitioners also argue that "the surety is a party to the contract with the United States and has a legal right in addition to his equitable lien, to receive from the United States the balance of the contract price" (Pet. 13–16). But, as the court below observed (R. 69), "the agreement of the United States that the surety should become subrogated to its principal's rights against it must be understood to have been made subject to the limitation that the Government should nevertheless have the priority given it" by R. S. 3466. Cf. *United States* v. *Knott,* 298 U. S. 544, 547. Moreover, any agreement to waive R. S. 3466 would be beyond the authority of the contracting officer.

The fundamental error common to both the petition and the brief *amicus curiae*[3] is the failure to recognize that the unqualified command of R. S. 3466 cuts across the rights of a subrogee in the same manner as it supersedes other legal or equitable rights. Regardless of the rights normally accorded to a surety by the courts, such rights must yield to the plain command that in case of an assignment for the benefit of creditors, the "debts due to the United States shall be first satisfied." There is no reason why the right of the United States to preference here as against its debtor's surety should be any less than it was in *United States* v. *Knott,* 298 U. S. 544, as against the State Treasurer in possession of a trust fund; in *United States* v. *Emory,* 314 U. S. 423, as against wage claimants; in *United States* v. *Texas,* 314 U. S. 480, as against state gasoline tax liens; in *United States* v. *Waddill Co.,* 323 U. S. 353, as against a landlord's lien and a municipal tax lien; or in *Illinois ex rel. Gordon* v. *United States, supra,* as against a State's claim to unemployment compensation taxes.

Both petitioners and the *amicus* urge that R. S. 3466 cannot apply because the withheld money in the hands of the United States does not belong either to the assignee or to contractor, but constitutes a trust fund retained by the

[3] A brief *amicus curiae* in support of the petition has been filed by the Association of Casualty and Surety Executives.

United States for the benefit of the person found to be entitled thereto. But that was the precise argument rejected by the Court in *United States* v. *Knott,* 298 U. S. 544, 548–551. There a Florida statute required all surety companies doing business to deposit certain securities with the State Treasurer, who held the fund in trust for the protection and benefit of all Florida claimants against the depositing surety company. Under the state statute the United States was not a beneficiary of the trust fund (298 U. S. at 549). This Court held that the creation of the trust fund did not divest the surety company of title thereto and that, in the absence of a specific, perfected lien, the United States was entitled to priority in payment out of the fund.[4] We submit that the fund here retained by the United States differed in none of its essential aspects

[4] This Court said (298 U. S. at 550–551):

"Obviously, the deposit did not divest the company's title to the securities. No one was appointed trustee; and, at the time of the deposit, there was no ascertainable beneficiary. Who would share in the proceeds of the securities could not be known until they were exhausted in satisfaction of judgments, or until the entry of the decree of distribution in a suit authorized by the 1933 amendment. While in the case at bar the Supreme Court declared that the deposit created a 'trust fund,' the term appears to have been used to connote an inchoate general lien for the benefit of those persons who may become entitled to be paid from the proceeds, either as unsatisfied judgment creditors, or as Florida creditors at the time when insolvency supervenes. Such an interest lacks the characteristics of a specific perfected lien which alone bars the priority of the United States."

from the fund involved in the *Knott* case. Until the insolvency of the contractor occurred, the surety, at the best, had only an inchoate lien. Cf. *United States* v. *Waddill Co.*, 323 U. S. 353, 359.

Notwithstanding petitioner's assertion (Pet. 5, 8–9), there is no conflict between the decision below and *Maryland Casualty Company* v. *United States*, 100 C. Cls. 513. In the *Maryland Casualty* case, where the Government was denied the right to offset a tax claim against the balance due under the contract, in derogation of the surety's interest, the court below denied priority to the Government on the ground that there had been no formal insolvency, as is "evidenced by a bankruptcy, receivership, or assignment for the benefit of creditors" (100 C. Cls. 513, 518). In the instant case the insolvency of the contractors has been manifested in one of the ways required by the statutes, namely, by a formal assignment for the benefit of creditors (R. 32).

Both petitioners and the *amicus* apparently are confused as to the scope of the ruling of the court below. They assert conflicts with subrogation cases wherein the United States was asserting no priority under R. S. 3466 but was, at the best, a stakeholder,[5] *e. g. Prairie State Bank* v. *United*

[5] Contrary to the assertion of the brief *amicus curiae* (pp. 2–3), there is no conflict between the decision below and the decisions in *Henningsen* v. *United States Fidelity & Guaranty Co.*, 208 U. S. 404; *Morgenthau* v. *Fidelity & De-*

States, 164 U. S. 227; they confuse cases in bankruptcy, where priority was denied the United States because of existing liens, with equity proceedings;[6] and they seek to establish the importance of the question here presented by urging that the ruling of the Court of Claims in *Maryland Casualty Company* v. *United States,* 100 C. Cls. 513, requires affirmance, although the question posed by that case is not here present.[7]

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posit Co., 94 F. 2d 632 (App. D. C.); and *Philadelphia National Bank* v. *McKinlay*, 72 F. 2d 89 (App. D. C.). In none of these cases was a claim asserted by the United States as against a claim of the surety, nor was R. S. 3466 involved.

[6] The petitioners cite (Pet. 11, 16–17, 19–20) a number of cases such as *United States F. & G. Company* v. *Sweeney*, 80 F. 2d 235 (C. C. A. 6), for the proposition that the subrogee of materialmen and wage earners takes priority over the claims of the United States for taxes. However, these cases have no significance in an equity proceeding. See Rogge, *The Differences in the Priority of the United States in Bankruptcy and in Equity Receiverships* (1929), 43 Harv. L. Rev. 251. Under Sec. 67 of the Bankruptcy Act (11 U. S. C. 107), a valid lien is superior to the trustee's title and the trustee takes subject to the lien. Accordingly, the order of priority fixed under Sec. 64a of the Bankruptcy Act (11 U. S. C. 104), which provides for the order of payment of the assets of the bankrupt estate, necessarily is junior to claims under existing liens.

[7] Petitioners and the brief *amicus curiae* heavily rely upon the refusal of the General Accounting Office to follow the doctrine of the *Maryland Casualty* case (Pet. 5–6; Br. 2–5). But that fact is obviously of no relevance here as it is not the doctrine of the *Maryland Casualty* case but an exception thereto that is here before this Court for review. If petitioners are dissatisfied with the action of the General Accounting Office in cases similar to the *Maryland Casualty* case, where there has been no formal act of insolvency, their

The mere statement of these contentions demonstrates their inapplicability to the present case.

CONCLUSION

The decision below is clearly correct and there is no conflict. It is therefore respectfully submitted that the petition for a writ of certiorari should be denied.

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AUGUST 1946.

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appropriate remedy is before the Court of Claims, which presumably will again apply the doctrine of the *Maryland Casualty* case in such situations.

APPENDIX

1. Rev. Stat. 3466, 31 U. S. C. 191, provides as follows:

> *Priority established.*—Whenever any person indebted to the United States is insolvent, or whenever the estate of any deceased debtor, in the hands of the executors or administrators, is insufficient to pay all the debts due from the deceased, the debts due to the United States shall be first satisfied; and the priority established shall extend as well to cases in which a debtor, not having sufficient property to pay all his debts, makes a voluntary assignment thereof, or in which the estate and effects of an absconding, concealed, or absent debtor are attached by process of law, as to cases in which an act of bankruptcy is committed.

2. Section 1 of the Act of August 24, 1935, c. 642, 49 Stat. 793, 40 U. S. C. 270a, provides in part as follows:

> (a) Before any contract, exceeding $2,000 in amount, for the construction, alteration, or repair of any public building or public work of the United States is awarded to any person, such person shall furnish to the United States the following bonds, which shall become binding upon the award of the contract to such person, who is hereinafter designated as "contractor":
>
> (1) A performance bond with a surety or sureties satisfactory to the officer awarding such contract, and in such amount as

he shall deem adequate, for the protection of the United States.

(2) A payment bond with a surety or sureties satisfactory to such officer for the protection of all persons supplying labor and material in the prosecution of the work provided for in said contract for the use of each such person. Whenever the total amount payable by the terms of the contract shall be not more than $1,000,000 the said payment bond shall be in a sum of one-half the total amount payable by the terms of the contract. Whenever the total amount payable by the terms of the contract shall be more than $1,000,000 and not more than $5,000,000, the said payment bond shall be in a sum of 40 per centum of the total amount payable by the terms of the contract. Whenever the total amount payable by the terms of the contract shall be more than $5,000,000 the said payment bond shall be in the sum of $2,500,000.

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